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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

STATEMENT AS TO JURISDICTION.

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BUTLER BROTHERS, A CORPORATION,

Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA.

JURISDICTIONAL STATEMENT.

Butler Brothers, appellant in the above entitled cause, and applicant for the allowance of an appeal to the Supreme Court of the United States from the Supreme Court of the State of California, respectfully represents that the basis upon which appellant contends that the United States Supreme Court has jurisdiction upon appeal to review the final judgment herein is as follows:

I.

The Statutory Provision Believed to Sustain the Jurisdiction.

The statutory provision believed to sustain the jurisdiction is section 237 (a) of the Judicial Code as amended (28 U. S. C. A. section 344 (a)). There is drawn in ques-

tion in this suit the validity of a statute of the State of California on the ground of its being repugnant to the Constitution of the United States. The decision of the California Supreme Court, which is the highest court of the State of California in which a decision in this suit could be had, was in favor of its validity.

The case is one in which, under the legislation in force when the Act of January 31, 1928, was passed, a review could be had in the Supreme Court of the United States on writ of error. Under said last named Act an appeal has been substituted for a writ of error.

Act of January 31, 1928, Chapt. 14, 45 Stat. 54, as amended by Act of April 26, 1928, Chapt. 440, 45 Stat. 466.

II.

Statute of the State, the Validity of Which is Involved.

The statute of the State of California, the validity of which is involved, is the Bank and Corporation Franchise Tax Act of California (Statutes 1929, p. 19, as amended). Section 4, subdivision 3, of that Act as it stood at the times here material, provided:

> "With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the constitution of this State or by this Act shall annually pay to the State for the privilege of exercising its corporate franchises within this State a tax according to or measured by its net income to be computed in the manner hereinafter provided at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event each such corporation shall pay annually to the State for the said privilege a minimum tax of twenty-five dollars."

Section 10 of said Act as it stood at the times here material provided:

> "If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, payroll, value and situs of tangible property, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.
>
> "If the Commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made."

Other pertinent provisions of said Act are appended hereto as Exhibit "A".

III.

Date of Judgment and Date of Application for Appeal.

The judgment sought to be reviewed is a final judgment of the Supreme Court of the State of California, the highest court of that State in which a decision in the suit could be had. The date of said judgment was March 21, 1941. A petition for rehearing, subsequently filed within the alloted time and considered by the California Supreme Court, was denied by that court on April 17, 1941. The judgment herein thereupon became final for the purpose of appeal

and review by the Supreme Court of the United States on said last mentioned date.

Citizens Bank v. *Opperman*, 249 U. S. 448.

The date upon which application for appeal is presented is June 28, 1941.

IV.

Nature of the Case and the Rulings of the Supreme Court of the State of California.

The nature of the case and the rulings of the Supreme Court of the State of California deemed to bring the case within the jurisdictional provisions relied on are as follows:

This suit was brought by appellant in the Superior Court of the State of California in and for the City and County of San Francisco against the State Treasurer of the State of California to recover certain additional franchise taxes assessed against appellant amounting to $3,798.43 and interest thereon amounting to $344.67. Said franchise taxes were assessed under the provisions of the Bank and Corporation Franchise Tax Act above mentioned. Said franchise taxes so assessed and said interest were paid by appellant to the said State Treasurer under protest.

The said franchise taxes were assessed with respect to the year 1936, but in accordance with the statute were determinable in accordance with the net income of appellant for the year 1935.

Appellant filed its return for the year 1936, from which return it appeared that appellant had a loss of $82,851 for the year 1935. Accordingly appellant paid the minimum tax of twenty-five dollars, upon the filing of the return.

On January 25, 1937, the Franchise Tax Commissioner of the State of California gave notice to appellant of the

proposed additional assessment of $3,798.43. Thereafter and in due time appellant filed with said Commissioner a written protest under oath. A copy of said protest was attached to the Complaint herein as Exhibit "A" thereto, and a copy is appended thereto as Exhibit "B". The protest stated, among other things, that it was conceived that appellant's position was supported by *Hans Rees' Sons, Incorporated*, v. *North Carolina*, 283 U. S. 123.

On August 5, 1937, the said Franchise Tax Commissioner gave written notice to appellant that he had affirmed said proposed additional assessment. On September 8, 1937, the said Franchise Tax Commissioner assessed said additional taxes in said sum of $3,798.43, with interest thereon from March 15, 1936. Thereafter and on September 16, 1937, appellant paid to the State Treasurer the amount of said additional assessment of $3,798.43, with interest thereon amounting to $344.67. Said payment was made under protest, which protest was in writing and which protest stated the grounds upon which said appellant claimed that said additional tax and all thereof was void. A copy of said protest was attached to the Complaint herein as Exhibit "B" thereto, and is appended hereto as Exhibit "C". Among other things, it was stated in the protest that the tax was

> "a tax upon business and transactions conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.
>
> "The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessment of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California."

The Complaint, filed October 18, 1937, specifically stated and claimed that said additional assessment and all thereof was void for each and all of the reasons and grounds set forth in said last named protest, to which reference was thereby made and which was incorporated in said Complaint as if therein set forth at length.

In his answer herein, the State Treasurer denied the allegations of the Complaint as to the invalidity of said assessment and further denied the allegations contained in said Exhibit "B" to said Complaint (Exhibit "C" hereto).

The case was tried upon a stipulation of facts. In that stipulation (paragraph 11 thereof) it was stated that appellant claimed

> "that its operations are not unitary in character; that its net income reasonably attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States."

The trial court sustained the validity of the tax and entered judgment against appellant. In its judgment the trial court adopted the stipulation of facts as its own findings of fact and simply held that the additional assessment "was duly and regularly made" pursuant to the statute in question.

Appellant thereupon appealed to the Supreme Court of the State of California. Subsequently that court, pursuant to certain amendments to the Bank and Corporation

Franchise Tax Act made in 1939, ordered that Charles J. McColgan, as Franchise Tax Commissioner of the State of California, be substituted in place of Charles G. Johnson as Treasurer.

Thereafter the California Supreme Court transferred the case to the District Court of Appeal for the Third Appellate District for hearing. The Appellate Court held the assessment void and accordingly reversed the judgment of the trial court, with directions to the trial court to enter judgment for appellant. A copy of the judgment and opinion of the Appellate Court is appended hereto as Exhibit "D".

Thereupon, upon defendant's petition, the California Supreme Court directed that the case be re-transferred to it for hearing.

Upon hearing in that court, the assessment was held valid. The California Supreme Court held that appellant's business was "unitary" in character and that the use of an allocation formula was made mandatory by the statute. The statute as thus construed and applied was also held valid and in no way repugnant to the Federal Constitution. The judgment of the trial court was accordingly affirmed. A copy of the judgment and opinion of the California Supreme Court is appended hereto as Exhibit "E".

Appellant's petition for rehearing was, as stated, denied on April 17, 1941. Among other things, the petition for rehearing called the court's attention to the fact that in its decision of the case it had indulged in various inferences and presumptions directly contrary to the express stipulation of the parties, upon which stipulation the case had been tried. (Stipulation of facts, paragraph 12.)

The California Supreme Court did not regard the case of *Hans Rees' Sons, Incorporated,* v. *North Carolina,* 283 U. S. 123, as controlling. That the court clearly misconceived

the effect of the holding in this case is apparent from the statement in its opinion (Exhibit "E", p. 50) that:

> "Careful analysis of the underlying legal principles considered in the Hans Rees' case compels us to conclude that it, like the Underwood Typewriter and Bass Ale cases, supra, recognized that where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained."

This statement can only be understood as meaning that where a business is "unitary" in character then, notwithstanding the evidence and the factual circumstances of the case, the use of an apportionment formula must necessarily be sustained. But this is precisely what this court in the *Rees* case did *not* hold.

The California Supreme Court also relied upon the decision of this Court in *North American Cement Corporation* v. *Graves*, 299 U. S. 517. In its opinion herein (Exhibit "E", p. 52) the court said that that case holds that the business there involved was a "unitary" business and that

> "separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation."

The California Supreme Court, just as in the case of the *Rees* case, misconceives the holding in the *North American Cement Corporation* case. It apparently was of the view that *the North American Cement Corporation* case was inconsistent with and in effect overruled the *Rees* case. But what this court held in the *North American Cement Corpo-*

ration case is precisely what is stated in the court's *per curiam* opinion that the New York statute

> "is valid upon its face and it has not been shown to have been so applied as to violate appellant's constitutional rights."

This Court did not hold that "separate accounting practice" is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation. Neither did this court hold that a formula allocation would be sustained where the established facts show the unreasonable and arbitrary effect of the application of the formula.

V.

Cases Sustaining the Jurisdiction of the United States Supreme Court to Review the Judgment of the California Supreme Court on Appeal.

In the cases decided by this Court where the question is as to the validity of a statutory method of apportionment of net income—with the consequent question as to the validity of the statute directing or authorizing such method of apportionment—the review has been by way of an appeal from the judgment of the State court.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;

Bass, Ratcliff & Gretton v. *State Tax Commissioner*, 266 U. S. 271;

Hans Rees' Sons, Incorporated, v. *North Carolina*, 283 U. S. 123;

N. & W. Ry. Co. v. *North Carolina*, 297 U. S. 682;

North American Cement Corporation v. *Graves*, 299 U. S. 517.

VI.

The Questions Involved Are Substantial.

The facts which were stipulated by the parties to this case show that appellant's business in California for the year 1935 resulted in a loss of $82,851.00, upon which no tax accrued for the year 1936 other than the minimum tax of twenty-five dollars.

Notwithstanding the stipulated facts, the Franchise Tax Commissioner under the asserted authority of the Bank and Corporation Franchise Tax Act (Section 10 thereof) applied an allocation formula which resulted in a claimed income of $93,551.50. By the application of the statutory allocation formula a loss of $82,851 was converted into a taxable income of $93,551.50.

Appellant makes no contention that a statutory method of allocation in determining net income is *per se* invalid or that a statute providing for such allocation method of determining income is void upon its face. Appellant does contend under the principles announced in the *Rees* case that the agreed facts in this case show that the application of the statutory method of apportionment has resulted unreasonably and arbitrarily and has operated to create a taxable net income where none existed in point of fact. As the California Appellate Court said in its opinion (Exhibit "D", p. 41):

> "We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California, and therefore not subject to its taxation power."

Appellant challenges the validity and constitutionality of the California Act here involved. As it has been construed and applied by the California Supreme Court to the stipulated facts, it serves to create income where none exists in fact, and, therefore, taxes income which is not within the jurisdiction of the State of California. In so doing appellant has been deprived of its property without due process of law and has been denied the equal protection of the laws in contravention of the Fourteenth Amendment. Just as in the *Rees* case, evidence which was found to be lacking in the *Underwood* and *Bass* cases is present in the instant case—evidence which shows that the method of apportionment provided for by the California statute

> "albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions"

within the State of California (*Hans Rees' Sons, Incorporated,* v. *North Carolina,* 283 U. S. 123).

The Facts.

The facts upon which this case was tried were stipulated by the parties and said stipulation of facts was adopted by the trial court as its own findings of fact. The stipulation appears in the printed transcript on appeal in the State Supreme Court. The facts so stipulated were as follows:

Butler Brothers, plaintiff herein (hereinafter called the Company), is a corporation organized under the laws of Illinois and is qualified to conduct business in California. Its corporate principal place of business is in Chicago, Illinois. The Company is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others, and selling such commodities to retailers only. It maintains and operates wholesale distributing houses at Chicago, Illinois, Minneapolis, Minnesota, St.

Louis, Missouri, Jersey City, New Jersey, Baltimore, Maryland, Dallas, Texas, and San Francisco, California. The San Francisco house was opened by the Company in 1928, being the last established of all the Company's houses, except that the one at Baltimore was acquired as a going concern in 1930.

Stocks of goods are maintained at each of the Company's houses hereinabove mentioned, from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the Company in the State of California are made from the San Francisco house. Each house handles its own sales and all solicitation, credit and collection arrangements in connection therewith. Books of account are kept at each house, wherein are entered the sales made thereat, the amounts paid for goods sold therefrom, transportation charges and other operating expenses, including the allocation of certain common expenses referred to in paragraph 4. It is agreed that all receipts from sales made in California have been credited to the San Francisco house.

The Company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which ordered, where the cost thereof and transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the Company or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses, as stated in paragraph 4. The greater part of other operating expenses incurred by the Company are directly and exclusively incurred at the respective houses, including such items as labor, rentals and similar expenses.

Paragraph 4 of the stipulation provided as follows:

> "There are certain items of expense which are incurred and paid by the Company for the benefit of all houses, the costs of which are allocated to the respective houses. No question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For the purposes of this case, and without prejudice to the claims of either party in any subsequent year, it is agreed that approximately 75% of the $100,091 overhead expense so allocated would have been incurred even though the San Francisco house was not operated, and that the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted. Included in such expenses are executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house."

The Company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California, determined as indicated in paragraph 2 of the stipulation, the costs of such merchandise, determined as indicated in paragraph 3, the direct expenses of the San Francisco house referred to in paragraph 3, and the indirect expense allocated to the San Francisco house in the manner described in paragraph 4. According to this computation, the San Francisco house operated at a loss of $82,851 during the year 1935.

In the year 1935 the operations of all houses of the Company produced a profit of $1,149,677. The additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such

percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company. It is also agreed that the Franchise Tax Commissioner, in imposing the additional assessment upon the Company, did not give consideration to any other factor or method of allocation. No question exists as to the accuracy of the Commission's calculation, nor respecting the use of the above formulas, if, by reason of the facts stipulated herein, a formula for allocation to California of a portion of the Company's income from all sources is proper. This stipulation is made without prejudice as to any other year than that on which the tax here involved is predicated.

In the year 1935 the total sales made by the Company at all houses amounted to $66,326,000, of which $5,206,000 were made from the San Francisco house. The purchases made for the account of the San Francisco house were substantially in the same proportion to total purchases. All purchases made by the Company for sale at its various houses are made through a central buying division. By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house operated by the Company.

The addition of purchases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by the Company for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would.

result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company. The stipulation in this paragraph shall not be deemed an admission by defendant that plaintiff is entitled to segregate the income of its San Francisco house from that of other houses for purposes of computing franchise tax.

It was further stipulated that it was claimed by the State Treasurer that by reason of the facts set forth in the stipulation

> "the operations of the Company are unitary in character and that the formula for allocation of income used by the Franchise Commissioner was lawful and proper and that the Company is not entitled, for the purpose of determining tax payable under the Bank and Corporation Franchise Tax Act, to use separate accounting of its San Francisco house to determine its net income in the State of California."

and further that

> "It is claimed by the Company that its operations are not unitary in character; that its net income reasonably attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States."

It was further stipulated that the stipulations of fact were without prejudice to appellant's claim

> "that its earnings in California are solely those derived from operation of its San Francisco house, and

> that it is taxable in California only in respect of such earnings, without regard to earnings from its operations in other states * * *"

and were without prejudice to the claim of the State Treasurer that appellant's

> "operations in California are of such a character as to be incapable of segregation from its other operations, and that plaintiff may be taxed on an allocation of its entire net income in the manner done by the defendant."

The Law.

The Tax Here Involved is Void. The California Statute as Construed and Applied by the California Supreme Court is Likewise Void. The Case of Hans Rees' Sons, Incorporated, v. *North Carolina, 283 U. S. 123, is Controlling.*

The tax here involved results from applying to appellant's business the statutory apportionment formula—notwithstanding that the agreed facts show that appellant's operations in California for 1935, upon which the 1936 tax is based, were conducted at an actual loss.

The application of the statutory apportionment formula has the effect of converting a *loss* of $82,851 into a taxable income of $93,551.50.

In *Hans Rees' Sons, Incorporated,* v. *North Carolina,* 283 U. S. 123, it appeared that the corporation there involved operated a manufacturing establishment in North Carolina. It bought hides, manufactured them into merchandise at its said factory and sold the manufactured merchandise in numerous other states. The North Carolina statute provided for the use of an apportionment method in determining the net income of the company in North Carolina. The taxing authorities applied the method, and the question was whether or not the tax was valid

and whether the statute as so applied was itself valid. The State court sustained the tax and held the statute valid. Reliance was had upon *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, and *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271. Evidence was sought to be introduced by the corporation tending to show that its income in North Carolina was in fact materially less than the amount of income resulting from the application of the statutory method of apportionment. The North Carolina Supreme Court disregarded this evidence and held that the apportionment method must in any event be applied. This court reversed the judgment, saying:

> "Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one State and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State. * * *
>
> "Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. * * * And the principle that was recognized in *National Leather Co.* v. *Massachusetts, supra,*

was that a tax could lawfully be imposed upon a foreign corporation with respect to 'the proportionate part of its total net income which is attributable to the business carried on within the State.' When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

In the *Underwood* case this Court had said:

"There is consequently nothing in this record to show that the method of apportionment adopted by the state was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

In the *Bass* case this Court had said that the situation was to all intents the same as in the *Underwood* case and that it was not shown any more than in the *Underwood* case

"that this application of the statutory method of apportionment has produced an unreasonable result."

In both the *Underwood* and *Bass* cases, therefore, this Court sustained the statute and the resulting tax.

In *North American Cement Corporation* v. *Graves*, 299 U. S. 517, which seems to be the chief reliance of the defendant herein, an apportionment method and resulting tax was sustained by this Court. In that case the judgments of the New York courts were upheld by this Court upon the specific ground that the statute

"is valid upon its face and it has not been shown to have been so applied as to violate appellant's constitutional rights." (Citing the *Bass* case.)

Defendant seems to think that the *North American Cement* case has overruled the *Rees* case. There is, however, no conflict whatsoever between these cases or between the *Rees* case and cases like the *Underwood* and *Bass* cases. Appellant here does not contend that the California statute is invalid on its face or that the apportionment method, which at least is permissible under the California statute under certain factual conditions, is *per se* invalid. Appellant has made the same contention throughout this case from its very inception, that under the factual situation here presented the apportionment method as applied by the California taxing authorities has resulted unreasonably, just as the apportionment method did in the *Rees* case, and we also point out the California Supreme Court has fallen into the same error as did the North Carolina court in the *Rees* case, namely, by holding that notwithstanding the factual situation an apportionment method is mandatory.

As heretofore stated, the application of the apportionment method in the instant case has resulted in converting what was an operating loss in fact to a taxable profit. Appellant contends that the factual showing in the instant case is even stronger than the factual showing in the *Rees* case, for in that case it appeared that there was some taxable gain at least in North Carolina. In the instant case there was a loss in fact of $82,851.

A State, we contend, cannot, consistently with the principles announced in the *Rees* case, merely by legislative or administrative *fiat*, convert a loss into a taxable gain.

That this Court does not regard the *Rees* case as overruled or in any way impaired is demonstrated by the fact of its recent citations in *James* v. *Dravo Contracting Co.*, 302 U. S. 134, and *Department of the Treasury of the State of Indiana, et al.*, v. *Wood Preserving Corporation*, — U. S. —, decided April 28, 1941.

When the Franchise Tax Commissioner first proposed to levy a tax based upon the opportionment method, appellant urged its invalidity under the principles of the *Rees* case. See Exhibit "A" to the Complaint (Exhibit "B" hereto). These objections were carried forward into the second protest made at the time the additional assessment was paid. See Exhibit "B" to the Complaint (Exhibit "C" hereto).

In its opinion herein the District Court of Appeals said (Exhibit "D", p. 41):

> "We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to an arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California and therefore not subject to its taxing power."

In marked contrast to the above holding, the California Supreme Court, as is shown by its opinion herein, contents itself by holding, first, that appellant's business is a "unitary" one and that, therefore, the apportionment method of determining the tax is of necessity valid and proper. That court states (Exhibit "E", p. 45):

> "If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state."

The principles upon which the California Supreme Court has gone in sustaining the validity of this tax cannot be reconciled with the principles announced by this court in the *Rees* case.

The Georgia Court has summed up the proposition very concisely in a recent decision there. After construing the Georgia statute to tax even domestic corporations only upon that portion of their business reasonably attributable to the trade or business within the State—as does the California statute—the court went on to determine the propriety of an allocation formula. The court said:

> "Where the business done within the State is distinctly divisible from the business done in other jurisdictions by the same corporation, ordinarily the total income from all operations can not be used as a basis of computation. See 75 L. Ed. 900, annotation. * * * The theories of allocation can have no place in the inquiry if the net income within the State stands on its own footing unmixed with outside business."
>
> (*Mexican Petroleum Corporation of Georgia* v. *Head*, Ga. App., 13 S. E. 2d, p. 887, 890.)

Among other cases referred to by the court was the *Rees* case.

VII.

The California Statute and the Tax Here Involved Are Void, Whether or not Appellant's Business is a "Unitary" One. As a Matter of Fact, However, Appellant's Business is Not Unitary in Character.

As stated, the California Supreme Court premises its conclusion upon the holding that appellant's business is "unitary". The type of business which this court viewed as "unitary" in the *Underwood, Bass* and *Rees* cases were manufacturing businesses. A manufacturing business does not lend itself to a degree of separableness to which a wholesaling merchandise business lends itself. The separableness of the various branches of a wholesaling merchandise business, like that of appellant's, is demonstrated from the

agreed facts herein. The determination of the net income of any one of the branch houses of appellant is not subject to the inherent difficulties which exist in the case of a manufacturing business. As shown in the stipulation of facts, each branch house, including that at San Francisco, is operated practically as an independent concern, excepting only that each branch house is charged with a proportionate share of certain common expense. And, inasmuch as each house is charged only with the actual cost of merchandise bought for wholesale, plus the transportation expense from the mill or factory to the given house, each house obviously is given the fullest possible advantage of the aggregate purchasing power of the company. Appellant's business is, in truth, merely an aggregation of seven independently operated businesses, albeit the seven houses are under a common legal ownership and control.

No question is raised in this case as to the reasonableness of the allocation of the so-called common expense of the seven houses. And no question is raised as to the accuracy of appellant's accounting practices at its San Francisco branch. The profit or income from appellant's California operations can only be the result of the sale of merchandise at the San Francisco house to customers residing in the State of California and elsewhere in the territory attributable to that house, all of which income or profit was included when appellant filed its return. Consistently with the *Rees* case, appellant might have attributed the whole of its so-called buying profit to Illinois, where its principal office is located and its central buying division operates. Appellant did not do so, however, but gave to its California branch its full share of such buying profit when it charged its California house with only the actual cost of the merchandise.

In its opinion (Exhibit "E", p. 46) the California Supreme Court said:

> "It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce."

But that is precisely what has been done in the instant case. Nevertheless, the California house still operated at a loss for the year of $82,851. Obviously had the California house not been so credited with its proportionate share of the "profits resulting from the purchasing power which such sales in the aggregate produce", the operating loss of the California house would have been correspondingly greater.

Where, as here, appellant's various houses are operated substantially as independent business units, and where, as here, the California house has received its proportionate share of the so-called buying profit, and where, as here, the indisputable figures to which the State has stipulated clearly and unmistakably disclose the amount of the operating gain or loss, an apportionment method, whether required or permitted by statute, cannot be sustained consistently with the *Rees* case.

The difficulties in determining the income in any given taxing State, in the case of a unitary business like that of manufacturing, are, of course, to be recognized. Such difficulties have no substantial existence in the case of a business like appellant's, operated as appellant's business is operated.

Under such circumstances there is every conceivable reason for applying the doctrine of the *Rees* case and determining net income or loss by the actual figures themselves—which figures, as in this case, reflect the actual facts of the situation—and no reason whatsoever for applying an apportionment formula.

It is universally recognized, we believe, that an apportionment formula is resorted to only to solve the difficulties inherent in accurately determining income in the various States of a so-called unitary business. Where, as here, and as the California Appellate Court so clearly pointed out, the income or loss is readily and accurately determinable by the figures themselves, no excuse exists for the application of a mere formula. To apply such a formula is apt to result, and has resulted in the instant case, in assigning to California income which was non-existent in fact in that State.

Respectfully submitted,

LELAND K. NEEVES,
JAMES S. MOORE, JR.,
Attorneys for Butler Brothers,
Appellant Herein.

EXHIBIT "A".

AN ACT TO CARRY INTO EFFECT THE PROVISIONS OF SECTIONS 14 AND 16 OF ARTICLE XIII OF THE CONSTITUTION OF THE STATE OF CALIFORNIA RELATING TO BANK AND CORPORATION TAXES, APPROVED MARCH 1, 1929, STATS. 1929, P. 19.

"4. *Financial corporation to pay tax.* • • •

• • • • • • •

(3) *Corporations other than financial doing business in this State to pay tax. Minimum tax.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars.

• • • • • • •

6. *The term 'gross income'*, as herein used, includes gains, profits and income derived from the business, of whatever kind and in whatever form paid; gains, profits or income from dealings in real or personal property; • • •

8. *Deductions allowed.* In computing 'net income' the following deductions shall be allowed:

(a) *Expenses.* • • •

(b) *Interest.* • • •

(c) *Taxes or licenses.* • • •

(d) *Uncompensated losses.* • • •

(e) *Bad debts.* • • •

(f) *Depreciation.* • • •

(g) *Depletion.* • • •

• • • • • • •

10. *Computation of tax on intrastate business.* If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made.

12. *Computation of net income.* The net income shall be computed upon the basis of the taxpayer's annual accounting period, fiscal year or calendar year as the case may be, in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of said commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

* * * * * * *

13. *Returns.* (a) Every bank and corporation shall, within two months and fifteen days after the close of its income year, transmit to the commissioner a return in a form prescribed by him, specifying, for the income year,

all such facts as he may by rule, or otherwise, require in order to carry out the provisions of this act.

* * * * * * *

15. *Form of returns.* Every return required by this act to be filed with said commissioner shall be verified by an executive officer of the bank or corporation. Blank forms of return shall be furnished by said commissioner on application, but failure to secure such a form shall not release any taxpayer from the obligation of making a return hereunder.

* * * * * * *

18. *Penalties for failing to file, or filing false returns.* Any bank or corporation failing or refusing to furnish any return hereby required to be made or failing or refusing to furnish a supplemental return or other data required by the commissioner, or rendering a false or fraudulent return, shall be guilty of a misdemeanor and subject to a fine of not exceeding five thousand dollars ($5,000) for each such offense.

* * * * * * *

24. *Interest on unpaid taxes.* (a) Interest upon the amount determined as a deficiency under the provisions of section 25 of this act shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the commissioner, and shall be collected as a part of the tax, at the rate of six per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed.

* * * * * * *

25. *Examination of returns. Notice of additional tax.* As soon as practicable after the return is filed, the Commissioner shall examine it and shall determine the correct amount of the tax. If the commissioner determines that

the tax disclosed by the original return is less than the tax disclosed by his examination he shall mail notice to the taxpayer at its post-office address (which must appear on its return) of the additional tax proposed to be assessed against it. Such notice shall set forth the details of the proposed additional assessment and of computing said tax.

Protest. Within sixty days after the mailing of said notice the taxpayer may file with the commissioner a written protest against the levy of the proposed additional tax, as computed by the commissioner, specifying therein the grounds upon which the protest is based. The protest must be under oath.

. . . . . ."

EXHIBIT "B".

(Exhibit "A" to the Complaint.)

Charles J. McColgon
Franchise Tax Commissioner
Sacramento, California

Re No. 8350.

DEAR SIR:

Protest is herewith made to your proposed additional franchise tax assessment amounting to $3,798.43.

The proposed additional assessment is based upon the theory that the general net income of the undersigned from the whole of its business transacted in the United States should be allocated to the State of California upon the basis as set forth in Schedule J of the return.

There was attached to the return a statement calling attention to the fact that the actual operations of the San Francisco branch house had resulted in an actual loss of $82,851 for the calendar year 1935, which statement was supported by a schedule attached showing the result of such operations. It is not understood that the figures there given are in any way disputed.

The question, therefore, is as to whether the statutory method of allocation should be given effect as against the actuality of the case.

Any method of allocation of the kind set forth in Schedule J is to a large extent arbitrary and is intended, and can be sustained, only as a means for arriving at net income attributable to the business carried on in the State of California. If such a method of allocation, or if any statutory or arbitrary method of allocation, works out in actual practice with a reasonable approximation of income attributable to California the method will be sustained. If, however, such method does not so work out, and results, in practical effect, in attributing to the State of California an unreasonable amount of income as compared to the business of the company done in its entirety and in other jurisdictions, or creates in California an income non-existent in fact, the statutory method of allocation must give way, and will not be sustained.

The undersigned respectfully insists that inasmuch as the actual results of the operation of its business in the State of California is a loss the statutory method of allocation is inapplicable, and that therefore it is subject only to a minimum tax.

It is conceived that the position here taken is supported by *Hans Rees' Sons, Incorporated v. North Carolina*, 283 U. S. 123.

Undersigned again states and insists, as it stated and insisted in its return as filed, that to impose a tax based upon the method of allocation set forth in Schedule J of the return is a violation of the undersigned's rights under both the California and United States Constitutions. An oral hearing is requested.

Respectfully submitted,

BUTLER BROTHERS,
By FRANK J. KEARNS,
Treasurer.

STATE OF ILLINOIS,
County of Cook, ss:

Frank J. Kearns being first duly sworn upon oath deposes and says that he is Treasurer of Butler Brothers, the

corporation whose name is subscribed to the foregoing protest; that he is familiar with the matters contained in said protest and that the same are true both in substance and in fact; and that as Treasurer he subscribed the name of said corporation to said protest and his own name as treasurer of said corporation.

FRANK J. KEARNS.

Subscribed and sworn to before me this 20th day of March, A. D. 1937.

A. F. BODENSTAB,
Notary Public.

[SEAL.]

EXHIBIT "C".

(Exhibit "B" to the Complaint.)

Hon. Chas. J. McColgan,
Franchise Tax Commissioner,
Sacramento, California,

and

Hon. Charles G. Johnson,
State Treasurer,
Sacramento, California.

GENTLEMEN:

There is paid herewith the sum of $4,143.10, being the additional tax imposed for the taxable year ended December 31, 1936 on the undersigned under the Bank and Corporation Franchise Tax Act, as set forth in "Notice of additional franchise tax proposed to be assessed", dated January 25, 1937, and in "Notice of action of Franchise Tax Commissioner upon taxpayer's protest", dated August 5, 1937, in the amount of $3798.43, and interest thereon from March 15, 1936 in the amount of $344.67. Said sum and all thereof is paid under protest, the grounds of said protest being:

Butler Brothers is a corporation organized and existing under the laws of Illinois, doing business in the State of

California. Its principal place of business is in the City of Chicago, County of Cook, and State of Illinois. It maintains and operates seven distributing or branch houses in the following localities: Chicago, Illinois; Minneapolis, Minnesota; St. Louis, Missouri; Jersey City, New Jersey (which includes sales offices and sample rooms in New York City); Baltimore, Maryland; Dallas, Texas, and San Francisco, California. The business of the company is the wholesaling of general merchandise. It maintains at its San Francisco house a stock of merchandise from which orders received and accepted at San Francisco are filled. It also maintains in the City of Los Angeles a sales and sample room. Stocks of merchandise are also maintained at the above-mentioned distributing houses, out of which orders are filled in the territory tributary to said respective houses. All of the sales made by Butler Brothers in California and territory tributary to the San Francisco house are made through the San Francisco house (including the Los Angeles sales and sample room), and the San Francisco house, together with said Los Angeles sales and sample room, is the only part of its business conducted within the State of California.

Separate accounts are kept of the operation of each branch of the establishment of Butler Brothers, including the San Francisco branch. All merchandise sold therein is charged at actual cost and other expenses of conducting said business are directly apportioned to said San Francisco branch, so that the exact income and expenses thereof can be ascertained. During the calendar year 1935, said San Francisco branch operated at a loss of $82,851.00 and the minimum tax under the Bank and Corporation Franchise Tax Act, to wit: $25.00, was paid by said Butler Brothers on or about March 15, 1937.

The additional assessment, payment of which is herewith protested, is predicated upon the allocation to California of income of Butler Brothers derived solely from operation of its business in states other than in California, and no part of the net income of Butler Brothers is derived from business done within the State of California.

The allocation to California of income derived from business done without the State of California does not fairly or at all assign to the State of California the net income of Butler Brothers reasonably attributable to the business done within this state and subjects Butler Brothers to double taxation.

The method of allocation followed by the Franchise Tax Commissioner is arbitrary and unreasonable and does not fairly or at all allocate to California the net income derived from business done within the State of California. To the contrary, the same purports to allocate to California income derived wholly from business done without the State of California. In fact, no net income has been derived from business done within the State of California.

The tax assessed upon Butler Brothers by the Franchise Tax Commissioner is a tax upon business and transactions conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.

The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessment of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California.

Respectfully submitted,

BUTLER BROTHERS,
(Signed) D. R. TREAT,
Comptroller.

STATE OF ILLINOIS,
County of Cook, ss:

D. R. Treat, being first duly sworn upon oath deposes and says:

That he is Comptroller of Butler Brothers, the corporation whose name is subscribed to the foregoing protest; that he is familiar with the matters contained in said protest and that the same are true both in substance and in fact; and that as Comptroller he subscribed the name of

said corporation to said protest and his own name as Comptroller of said corporation.

(Signed) D. R. TREAT.

Subscribed and sworn to before me this 10th day of September, 1937.

[SEAL.] (Signed) A. F. BODENSTAB,
Notary Public in and for the County of Cook, State of Illinois.

(Endorsed:) Filed October 18, 1937. H. A. van der Zee, Clerk, by F. H. Kockler, Deputy Clerk.

EXHIBIT "D".

San Francisco—J. J. Trabucco, Judge.

Civil No. 6464. Third Appellate District.

May 18, 1940.

101 C. A. D. 612.

BUTLER BROTHERS (a Corporation), *Plaintiff and Appellant,*

v.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner of the State of California, in the Place and Stead of Charles G. Johnson, State Treasurer of the State of California, *Defendant and Respondent.*

This action was brought to recover the sum of $4,143.10, being the amount of taxes and interest thereon paid to respondent under protest. Judgment was entered in favor of respondent, and plaintiff appealed therefrom.

The cause was submitted upon an agreed statement of facts which may be summarized as follows:

Plaintiff and appellant, Butler Brothers (herein called "the Company"), is an Illinois corporation, having its principal corporate office at Chicago. It is engaged in the wholesale dry goods and general merchandise business, purchas-

ing from manufacturers and others, and selling to retailers only. It operates seven distinct wholesale houses at Chicago, Jersey City, Baltimore, Minneapolis, St. Louis, Dallas and San Francisco. Each of these houses serves a separate trade territory. At each house stocks of goods are maintained, from which sales are made in its territory. Each handles its own sales, and all solicitation, credit and collection arrangements in connection therewith, and keeps books of account showing the operations of the house. All sales in California were made from the San Francisco house and all receipts credited thereto.

The greater part of the operating expense of the houses is directly and exclusively incurred at the respective houses, including such items as labor, rentals, etc. There are, however, some common expenses such as executive salaries and corporate overhead and the expense of operating a central buying division and a central advertising division. These expenses are apportioned to the respective houses on bases which, it is agreed, are in accord with recognized accounting practice, and the accuracy and propriety of such bases of apportionment are here conceded. The aggregate of such common expenses so charged to the San Francisco house for the year 1935 was $100,091, of which, it is agreed, approximately 75 per cent would have been incurred whether or not the San Francisco house were operated. Except for such common expenses, each house is operated independently of each other house.

Through a central buying agency goods required for resale in the various houses are ordered, but such goods are shipped directly from the manufacturer to the houses, where the cost thereof, with transportation charges thereon, is entered on the books of the house. No charges are made against any house for the benefit of the company, or any other house by reason of such centralized purchases, but the actual cost of operating the central buying division is allocated to the houses as stated in the preceding paragraph. By reason of the volume of purchases so made, more favorable prices are obtained than would be obtainable in respect to purchases for the account of any individual house, but addition or subtraction of purchases in

the volume made for the San Francisco house would have no effect on the prices obtainable for the remaining houses.

The accounts of the San Francisco house, computed by deducting from the gross receipts from all sales made therefrom (which includes all sales made and business done in California) the actual cost of merchandise and other direct expenses, and the apportioned share of common expenses previously described, showed for the year 1935 a loss of $82,851. Within the time allowed by law a report showing this loss was made and the minimum tax of $25 was paid for the year 1936. During the year 1935 the operations of all houses of the company produced a profit of $1,149,677. The commissioner subsequently assessed an additional tax of $3,798.43, which, with interest amounting to $344.67, was paid under protest on September 16, 1938. The additional assessment was predicated on the allocation to California of 8.1372 per cent of the company's total income derived from all sources. This percentage was a mathematical average of the percentages which the value of the tangible property, payroll and gross sales attributable to California bore to the corresponding items of all houses of the company. If an allocation is proper, use of the particular percentage here used is not questioned.

The tax in question was levied under the provisions of section 10 of the Bank and Corporation Franchise Tax Act (General Laws, Act 8488, vol. 2, p. 3851). That section provides:

"If the entire business of the bank or corporation is done within this state, the tax shall be according to, or measured by its entire net income; and if the entire business of such bank or corporation is not done within this state, the tax shall be according to, or measured by that portion thereof which is derived from business done within this state. The portion of net income derived from business done within this state, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done

within this state and to avoid subjecting the taxpayer to double taxation * * *."

It is contended by appellant that the method by which the tax was fixed and computed was unauthorized and unlawful, and that such method had the effect of taxing plaintiff on, and in respect to income derived from sources beyond the jurisdiction of the state. This resulted, it is contended, in a denial of due process of law, and of the equal protection of the law, in violation of the Fourteenth Amendment of the Constitution of the United States.

On the other hand, respondent contends that the tax was levied upon income from business derived from within this state; that such business was unitary in character; and that the state was therefore justified in applying the formula method in arriving at the net income of appellant.

The sole question presented is whether the franchise commissioner should have adopted the separate accounting method in computing the franchise tax, or whether it was proper and legal for him to have used the formula system. If the first method is used, only the minimum tax of $25 would be due. Under the second method, which was actually applied here, the tax amounted to $3,798.43. The first method shows a loss in the California operations of appellant amounting to $82,851. Under the second, respondent showed that appellant enjoyed and received a net income from the business done in California amounting to $95,000. *In respect to net income, the two methods are some $177,851 apart.* Both methods are described in the stipulated facts above. The first is obviously based upon strict and accurate accounting procedure, while the second is the application of a set formula which has been approved in many jurisdictions in those cases where interstate operations are carried on, and where, from the nature of such operations, income cannot be properly allocated by separate accounting methods. Plain instances which justify the application of the formula method would be telegraph, telephone, railroad and express companies. If there is any evidence to sustain a finding that the operations of appellant in California, during the year 1935, contributed to the net income derived from its entire operations in the United States, it would seem as

though the method used was a proper one. Such income would be within the purview of the statute quoted above—"The portion of the net income derived from business done within this state." When the formula method is adopted by the taxing power, the burden of proof is upon the taxpayer to show that such method has been applied unreasonably and arbitrarily. (*Hans Rees' Sons* v. *State of North Carolina*, 283 U. S. 123.)

Appellant earnestly contends that the evidence is insufficient to justify the imposition of the formula. It points out that there is nothing in the stipulated facts which would justify a finding that it was doing a unitary business, and even if there were such evidence, the method used operated arbitrarily and unreasonably in respect to appellant's business. It is agreed by all parties that the formula of allocation to California of a portion of appellant's income from all sources, is proper, if the facts of the case justify the application of a formula. The question is not whether the formula used is fair and proper, but whether, under the facts here, there should be any allocation at all.

The factual structure of the case is relatively simple. Appellant is engaged in buying merchandise from manufacturers and others, and selling to retailers only. It does no manufacturing. It maintains a central buying division, but goods are shipped directly from the manufacturer to the houses in the several states, where the cost thereof and transportation charges are entered upon the books of the house. Further facts appear in the summary given above.

It is fundamental that jurisdiction to tax is dependent upon jurisdiction of the person or transaction sought to be taxed and that for a state to tax property on transactions beyond its jurisdiction is a denial of due process of law and of the equal protection of the laws. (*Frick* v. *Pennsylvania*, 268 U. S. 473.) Where, however, property located in two or more states derives a value from its unity of use, allocation of the composite value on a fair and reasonable basis will be sustained. The familiar illustration of this principle is in the assessment of railroad property. (*The Railroad Tax Cases*, 92 U. S. 575.) Referring to a unitary business, "That term is simply descriptive, and primarily means

that the concern to which it is applied is carrying on one kind of business—a business, the component parts of which are too closely connected to each other to justify division of separate considerations, as independent units." (*Maxwell* v. *Kent-Coffey Mfg. Co.*, 204 N. C. 365, 168 S. E. 397.) It has further been held that unity of *use* is something more than mere unity of *ownership*. (*Adams Express Co.* v. *Ohio*, 165 U. S. 194-222.) The allocation may be made by the application of a formula, which is based upon certain factors. The following excerpt from the stipulated facts describes the formula used and the manner of its application:

"In the year 1935, the operations of all houses of the Company produced a profit of $1,149,677. The additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company."

The fact that a corporation does business in more than one state does not necessarily justify the application of a formula to ascertain the tax. In *Hans Rees' Sons* v. *State of North Carolina, supra;* the court held:

"But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State."

Where, however, a business is unitary in character, that is, where its separate parts cannot be fairly considered by themselves, and where the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula has been sustained. (*Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266

U. S. 271; *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113.) Aside from the question as to the propriety of applying a formula here, and paramount over all other considerations, is the question whether or not it reasonably appears that a portion of the total net income of appellant was "derived from business done within this State." (Sec. 10 of Act 8488—fully quoted above.)

The only factor called to our attention by respondent which might point to a unitary business is the central buying power exercised by the headquarters of appellant in Illinois. The state argues that even though the California house lost money during the year 1935, the operations conducted during that year actually brought a profit to the corporation. They contend that the disposal of some $5,000,000 worth of merchandise during the time mentioned, increased the purchasing power of appellant, and thus permitted it to buy for its other houses, through volume purchases, at a price lower than it otherwise would have secured. It appears, however, that the parties have stipulated otherwise. We quote from the agreed facts: "A reduction in the volume of purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company."

Most of the cases cited by respondent, with one exception, involve corporations which are engaged in *manufacturing*. In those instances a manufacturing profit was made by the corporation before the merchandise was shipped to another state. This is true of the Underwood case, *supra*. Here, none of the merchandise was manufactured by appellant. It was engaged solely in buying and selling. There are cases where a corporation engaged in buying and selling has been held subject to the payment of income taxes in one of the states where it has been doing business. In *International Elevator Co.* v. *Thoresen*, 58 N. D. 776, 228 N. W. 192, a company which bought and sold grain was held liable for the payment of an income tax in the state of North Dakota. It bought grain in that state and shipped it for resale in other states. The corporation filed a return showing only income derived from sales in North Dakota. It failed to account for sales outside the state, and contended that only trans-

actions within the state should be considered in fixing its income. It showed that it had lost some $85,000 on transactions *within the state*. Its net profit from all its operations in several states amounted to $249,515.11. A tax of $2,937.98, computed by a formula, was upheld. The case was clearly one where a separate accounting system did not disclose the income received from shipment and sale of grain outside the state. The return by the elevator company included only income received from sales at North Dakota elevators. The case of *Montgomery Ward & Co.* v. *Kansas Tax Commission*, 151 Kan. 159, 98 Pac. (2d) 143, throws little light upon the question. No attempt was there made by the state to base a tax upon the net income of the corporation outside the state of Kansas. The only question was whether or not the corporation was entitled to charge against its Kansas income a proportionate share of certain expenses incurred outside the state. The court held in the affirmative.

Appellant relies strongly upon the case of *Standard Oil Co.* v. *Wisconsin Tax Commission*, 223 N. W. 85. Wisconsin taxes corporations on a basis very similar to our Bank and Corporation Franchise Tax Act and provides for allocation of income in a manner very like section 10. A company engaged in the production, refining and sale of petroleum products but engaged only in selling within Wisconsin was taxed on the basis of a statutory allocation of income from the entire operation. In that case it was shown that accurate accounting of the operations of the various branches existed. The court there held:

"In the enactment of the statute relating to the allocation of income of persons doing business within and without the State, the declared legislative purpose is to make a reasonable and equitable distribution of the taxpayer's income to the end that that part of the income justly assessable in the State of Wisconsin may be ascertained. The statute does not enjoin upon the Commission the use of that method which will produce the largest amount of taxable income but rather that method which will most justly apportion the income properly taxable in Wisconsin. Here it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by the application

of proper accounting methods. . . . There are some operations which from their very nature produce an income which cannot be properly allocated by separate accounting methods, instances of which are the telegraph, telephone and express companies. They stand ready to serve whoever may apply for service and the entire operation constitutes a unit of service. *That is not the case with the manufacturing and sales business, particularly so where the accounts are so kept as to be readily separable.*"

We regard the foregoing case as very persuasive authority to the effect that a separate accounting method should be applied in the instant case.

We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California, and therefore not subject to its taxing power.

The facts found do not support the judgment, and it is ordered that the judgment be reversed, with directions to the trial court to enter judgment in favor of appellant.

TUTTLE, *J.*

We concur:

PULLEN, *P. J.*

THOMPSON, *J.*

EXHIBIT "E".

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA, IN BANK

S. F. No. 16157

BUTLER BROTHERS, a Corporation, *Plaintiff-Appellant*,

vs.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner of the State of California, *Defendant and Respondent.*

(Filed March 21, 1941, B. Grant Taylor, Clerk. By S. C. S., S. F. Deputy.)

This action was brought to recover an additional assessment made by the defendant as Franchise Tax Commis-

sioner under authority of the Bank and Corporation Franchise Tax Act (Statutes 1929, Ch. 13, as amended) for the taxable year 1936, based upon income for the year 1935, paid by plaintiff under protest. Judgment was entered in favor of defendant, and plaintiff appealed therefrom.

The cause was submitted upon an agreed statement of facts, which may be summarized as follows:

Plaintiff, Butler Brothers (herein called "the Company"), is an Illinois corporation, having its principal corporate office at Chicago. It is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others and selling to retailers only. It operates seven wholesale distributing houses at Chicago, Jersey City, Baltimore, Minneapolis, St. Louis, Dallas and San Francisco. Each of these houses serves a separate trade territory. At each house stocks of goods are maintained, from which sales are made in its territory. Each house handles its own sales, and all solicitation, credit and collection arrangements in connection therewith, and keeps books of account showing the operations of the house. All sales in California were made from the San Francisco house and all receipts credited thereto.

Part of the operating expense of the houses is directly and exclusively incurred at the respective houses, including such items as labor, rentals, etc. The remainder consists of certain items of common expense such as executive salaries and corporate overhead and the expense of operating a central buying division and a central advertising division. These expenses are allocated to the respective houses on bases which, it is agreed, are in accord with recognized accounting practice, and the accuracy and propriety of such bases of apportionment are here conceded. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091, of which, it is agreed, approximately seventy-five per cent would have been incurred even though the San Francisco house was not operated. Except for such common expenses, each house is operated independently of each other house.

The company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which

ordered, where the cost thereof and the transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the company, or any other house by reason of such centralized purchasing, but the actual cost of operating the central buying division is allocated to the houses, as stated in the preceding paragraph. By reason of the volume of purchases made by the company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house, but addition or reduction in the volume of purchases in an amount equal to the purchases made for the account of the San Francisco house would have no effect on the prices obtainable for the remaining houses.

The company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California the costs of such merchandise, the direct expenses of the San Francisco house, and the apportioned share of common expenses previously described. According to this computation the San Francisco house operated at a loss of $82,851 for the year 1935. Within the time allowed by law a report showing this loss was made and the minimum tax of $25 was paid for the year 1936. In the year 1935 the operations of all houses of the company produced a profit of $1,149,677. The Franchise Tax Commissioner subsequently assessed an additional tax of $3,798.43, which, with interest amounting to $344.67, was paid under protest on September 16, 1938. The additional assessment was predicated on the allocation to California of 8.1372% of the total income of the company derived from all sources, such percentage having been determined by mathematical average of the percentages which the value of the tangible property, payroll and gross sales attributable to California bore to the corresponding items of all houses of the company. If an allocation is proper, use of the particular percentage here is not questioned.

The tax in question was levied under the provisions of section 10 of the Bank and Corporation Franchise Tax Act (General Laws, Act 8488, Vol. 2, p. 3858; Stats. 1929, p. 19:

amended by Stats. 1931, p. 2226; Stats. 1935, p. 965), which, so far as here involved, reads as follows:

"If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation."

It is claimed by appellant that the method by which the tax was fixed and computed was unauthorized and unlawful, and that such method had the effect of taxing plaintiff on and in respect to income derived from sources beyond the jurisdiction of the State. This resulted, it is contended, in a denial of due process of law and of the equal protection of the law; in violation of the Fourteenth Amendment of the Constitution of the United States.

On the other hand, respondent contends that the tax was levied upon income from business derived from within this state, that the operations of the company are unitary in character, and that the formula for allocation of income used by the Franchise Tax Commissioner was lawful and proper in arriving at the net income of appellant from business done in California—computed to be approximately $95,000.

The sole question to be determined on this appeal is whether it is lawful and proper for the respondent, as Franchise Tax Commissioner, to insist upon use of the formula for allocation of income in a case such as this, or whether the company is entitled to use the separate accounting of its San Francisco house to determine its net

income in the State of California. The answer to this question depends entirely on the nature of the business conducted within and without the State by appellant, a foreign corporation. It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer (Adams Express Co. *v.* Ohio State Auditor, 165 U. S. 194, 166 U. S. 185, 17 S. Ct. 604; Pullman's Palace Car Company *v.* Pennsylvania, 141 U. S. 18, 11 S. Ct. 876; State Railroad Tax Cases, 92 U. S. 575, 23 L. Ed. 663). In the early cases in which the unit rule first made its hesitating appearance there was always a physical link, a palpable unity of substance, a binding together by a system of rails or by telegraph wires. (State Railroad Tax Cases (1875), supra; Western Union Telegraph Co. *v.* Taggart (1896), 163 U. S. 1, 16 S. Ct. 1054, 41 L. Ed. 49). Then in Adams Express Co. *v.* Ohio State Auditor (1897), supra, the standard unity of substance was openly replaced by one of unity of use and management. This decision clearly recognized that in assessing tangible property for taxation, its value producing qualities in connection with other pieces of tangible property outside the state must be considered. If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state. (Underwood Typewriter Co. *v.* Chamberlain, 254 U. S. 113, 41 S. Ct. 45). Such income would be within the purview of the statute quoted above—"The portion of the net income derived from business done within this State".

Preliminary to analysis and discussion of the cases cited by the parties as bearing on the issue involved in the instant case, we shall review briefly the relatively simple factual structure as it is logically reflected in the modus operandi of appellant's business. The company is engaged in buying merchandise from manufacturers and selling to retailers only. It maintains a central buying department outside the state. By its large scale purchasing activity, appellant concededly is able to buy at lower prices than would otherwise be possible, thus realizing a purchasing saving. But it is able to buy in large quantities only because it is able to sell in large quantities, so that it is apparent that the purchasing saving is made possible only because of the sales. Furthermore, it is pertinent to observe that the saving is not turned into profit until the sales are made. Thus, the purchasing activities and the sales activities are interdependent and supplement one another to form one single, unitary business. Appellant here calls attention to the fact that the parties stipulated that if an amount of sales equal to those of the San Francisco store were eliminated, the volume would not be reduced enough to affect the price at which appellant bought. On this ground appellant urges that the San Francisco store is the one which does not affect purchase price differentials. But, as the respondent urges, it also should be noted that it was stipulated that appellant bought at lower prices because of the great volume it obtained through having several stores. The weakness of appellant's argument is readily apparent when pursued to its logical conclusion. If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce. Other salient factors indicating

the unitary character of appellant's business are the central advertising division and the central accounting and management division. The former enables appellant to spread its advertising cost over more stores and units and to secure its advertising at a lower cost per unit, thereby making possible advertising opportunities unavailable to a single store; as to the latter (central accounting and management department), the volume of business resulting from operation of the company's several stores permits better as well as more costly services of accounting and management to be available to each store, whereas if each were separately operated, services of such quality in all probability would be too expensive to be practicable.

The Supreme Court of the United States has repeatedly held that companies whose income has resulted from a series of transactions beginning with manufacture in one state and sales in another were unitary businesses. (Underwood Typewriter Co. *v.* Chamberlain (1920), 254 U. S. 113, 41 S. Ct. 45, 65 L. Ed. 165; Bass, Ratcliff & Gretton, Ltd., *v.* State Tax Commission (1924), 266 U. S. 271, 45 S. Ct. 82, 69 L. Ed. 282). While it is not clear from the record whether appellant manufactured any of its goods in the State of Illinois or elsewhere, it is conceded that appellant purchased most of its goods through the Illinois central purchasing arrangement. This central purchasing factor is completely analogous and comparable to the manufacturing activities in the Underwood Typewriter and Bass Ale cases, supra, wherein we find recognition of the principle that income from sales is attributable to the series of transactions from which the income is derived. Since these two leading cases involve the validity of allocation by applying a percentage formula to the entire income in order to determine the income taxable in a state where the business is only partly carried on, we shall consider them in some detail.

In Underwood Typewriter Co. *v.* Chamberlain, supra, the company manufactured its typewriters in Connecticut and sold them generally throughout the country. Using a statutory method of allocation (by assigning to the state that portion of the total income which the value of real and tangible personal property within the state bore to the total

value of such property within and without the state), Connecticut determined that 47 per cent of the company's net income was derived from property and transactions within the state. The company objected to the method of apportionment on the ground that only a little over 3 per cent of its net receipts was collected in Connecticut. The court upheld the Connecticut allocation for the reasons expressed in the following excerpt from the opinion at pages 120-121:

"* * * The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. 'The plaintiff's argument on this branch of the case,' as stated by the Supreme Court of Errors, 'carries the burden of showing that 47 per cent. of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which 80 per cent. of its gross earnings was derived after paying manufacturing costs.' The corporation has not even attempted to show this; and for aught that appears the percentage of net profit earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

Here we have clear and concise expression of the only limitation on the use of a formula in the allocation or apportionment of income of a unitary business, to-wit, the formula must not be intrinsically arbitrary, and it must not produce an unreasonable result.

Bass, Ratcliff & Gretton, Ltd., *v.* State Tax Commission, supra, involved a British corporation engaged in brewing

and selling Bass' ale. Its brewing was done and a large part of its sales were made in England, but it had imported a portion of its product into the United States, which it sold in branch offices maintained in New York and Chicago. During the income year in question, the entire business was operated at a substantial profit, but the company, for federal income tax purposes, reported no income for that year from its business within the United States. Presumably this result was reached by computing its income under the separate accounting method. The Tax Commission of the State of New York assigned to New York that portion of the total net income which the value of certain specified classes of assets within New York bore to the total value of such assets within and without the state. The company resisted the tax on the ground that it derived no income from New York and that the action of the Commission was an attempt to assign to New York a portion of the company's income derived from business carried on outside the United States. The court, however, upheld the action of the Commission and at page 282 of its opinion expressed its views regarding the allocation of income of unitary businesses as follows:

"So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business. In Wallace v. Hines, 253 U. S. 66, 69, it was recognized that a State, in imposing an excise tax upon foreign corporations in respect to doing business within the State, may look to the property of such corporations beyond its borders to 'get the true value of the things within it, when they are part of an organic system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible

way that it adds to the value of the (property) and the rights exercised in the State.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State."

Thus, it is apparent from the language of this case that with respect to a unitary business, income from the taxing state as determined by an allocation formula was controlling, where the statutory method of apportionment was not shown to be arbitrary or unreasonable.

In support of its argument that respondent's application of the formula would tax income from transactions taking place beyond the jurisdiction of California, appellant relies heavily upon Hans Rees' Sons *v.* State of North Carolina (1931), 283 U. S. 123, 51 S. Ct. 385, 75 L. Ed. 879. But an examination of the facts and legal principles involved therein reveals that there is nothing in that decision to support appellant's argument. The corporation was engaged in the business of tanning, manufacturing and selling leather products, and its principal manufacturing and supply house was located in North Carolina. Extensive sales and purchasing activities were carried on outside the state. The corporation offered proof which tended to show that for the years in question the average income having its source within the state was but 17 per cent of the total and actually showing that the percentage of its income attributable to North Carolina did not in any event exceed 21.7 per cent of the total, whereas the statutory formula, restricted to tangible property, had allocated to North Carolina approximately 89 per cent of the income. The opinion clearly recognized the necessity of using a method of apportioning to a state that portion of entire income which is "reasonably attributable to the processes conducted within the borders of that State," but because the particular statutory formula employed, consisting simply of the property factor, attributed to North Carolina a percentage of income "out of all appropriate proportion to the business transacted by the appellant in that State," the court refused to approve the result reached by the formula. Careful analysis of the underlying legal principles considered in the Hans Rees' case compels us to conclude that it, like the

Underwood Typewriter and Bass Ale cases, supra, recognized that where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained.

The latest expression of the Supreme Court of the United States on this subject brought to our attention is North American Cement Corporation *v.* Graves (1936), 269 N. Y. 507, 199 N. E. 510; 243 App. Div. 834, 278 N. Y. S. 920; 299 U. S. 517, 57 S. Ct. 311, wherein it is significant to note that Bass, Ratcliff & Gretton, Ltd., *vs.* State Tax Commission, supra, was cited in support of its holding that income from the taxing state as determined by an allocation formula was controlling, although the taxpayer showed that by separate accounting much less income would be allocated to the taxing state. The United States Supreme Court and the New York Courts from which the taxpayer appealed all decided the case with memorandum opinions, so the facts must be obtained from the record in the case (Volume 2253, United States Supreme Court Records). The taxpayer, a foreign corporation, owned and operated three cement plants and one lime plant and sold the products thereof. Two of the cement plants were in New York, one was in Maryland and the lime plant was in West Virginia. The corporation operated its four plants separately and sold their products in separate districts, kept separate accounts for them, and sold very little of the output of the West Virginia and Maryland plants in New York. The Tax Commission allocated the net income of the corporation by a one factor formula (property factor) for the income years 1925, 1926, 1927 and 1929. By this means large incomes were allocated to New York for each of those years. The corporation, by an elaborate separate accounting system, showed that for 1925 the New York income was much less than that allocated to that state by the formula, and that for 1926, 1927 and 1929 the corporation sustained large losses from its New York business instead of deriving from New York the income allocated to it by the formula. In the face of this evidence the Supreme Court of the United States, affirming the New York Court of Appeals and Ap-

pellate Division, Supreme Court, held that the results of the formula were controlling and upheld the assessment thereon.

The significance of this decision on two points involved in the instant case is readily apparent: (1) it holds that the operations of four separate manufacturing plants, one of them making a different product from different materials than the others, are so interrelated as properly to be treated as *unitary;* (2) it holds that separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation. On both points this decision is contrary to Standard Oil Co. v. Wisconsin Tax Comm. (1929), 197 Wis. 630, 223 N. W. 85, on which appellant strongly relies in asserting that the results of its separate accounting must be accepted by respondent as tax administrator. However, careful examination of the factual situation in this Wisconsin case reveals a peculiar distinguishing allocation factor which undoubtedly exerted a strong influence on the result reached by the court there.

In Standard Oil Co. v. Wisconsin Tax Com., supra, the plaintiff company produced, refined, transported and marketed petroleum products in eleven mid-western states, and its property within Wisconsin consisted principally of tanks and filling stations required to supply the Wisconsin demand. Fifty-four per cent of the oil stored in these tank farms was sold to Wisconsin and forty-six per cent without the state. Plaintiff company did practically no manufacturing in Wisconsin. The controversy arose as to the manner in which that part of its income properly taxable in the state of Wisconsin should be ascertained. The Tax Commission used a ratio method provided in the statute for unitary business transactions conducted within and without the state. The company contended that its income should be ascertained by the allocation and separate accounting method by which the Wisconsin business was charged *at the market price* with all products received by it, with the expense of transacting the business, including a proper allocation of general or overhead expenses and office accounting, that there should be credited to Wisconsin the gross amount received from sales of goods within the state,

and that the difference constituted the taxable income of plaintiff company. The court upheld the plaintiff company's contentions. The distinction to be noted here differentiating this Wisconsin situation from the instant case is the fact that the products furnished to the Wisconsin business were charged at "*market value*" rather than at cost. *Market value* (at wholesale) included reasonable *profit*, and such profit became income to the company in the outside states. This amounted in effect to allocation of income as between Wisconsin and the other states. That the plaintiff company's arbitrary method of assigning a fictitious market value at which the selling division was deemed to have "bought" the oil from the refining division greatly impressed the Wisconsin court and furnished reason for its distinction of the Underwood Typewriter case, supra, appears from the following language at page 639 of the opinion: "Nor do we find anything in Underwood Typewriter Company v. Chamberlain, 254 U. S. 113, 41 S. Ct. 45, inconsistent with our conclusion in this case. There, there was no separation on the basis of market value between the operations of the manufacturing department and the sales department as there is in this case. We perceive no reason why, under the facts in this case, the profits derived from the sales operations should not be ascertained, so far as plaintiff is concerned, as they would be if the sales operations were conducted by a separate corporate entity." Whether the Wisconsin court by its decision placed too much emphasis on the value of fictions is not our concern here; suffice it to say that the Wisconsin court manifestly sanctioned the practice of charging the products to the Wisconsin end of the business at *wholesale market prices* in determining income derived in Wisconsin. The distinction between *market price* and *cost* cannot be ignored; the former includes profits and the latter does not; and it is this differentiation which decidedly limits the applicability of the Wisconsin case to the instant factual situation.

The unitary character of the buying and selling business has been recognized in International Elevator Co. v. Thoresen (1929), 58 N. Dak. 776, 228 N. W. 192, and Great Atlantic & Pacific Tea Co. v. Grosjean (1937), 301 U. S. 412, 57 S. Ct. 772, 81 L. Ed. 1193. In the Thoresen case,

supra, plaintiff company operated a line of grain elevators, about half of which were in Montana and the other half in North Dakota. The company's income was derived chiefly from the sale, outside the state, of grain bought within North Dakota, and the question was whether North Dakota could assess a tax upon any part of the income from the sales outside the state. Like appellant here, the plaintiff company there tried to apportion its income by separate accounting. That procedure was held improper and allocation of income was sanctioned to North Dakota wholly out of proportion to the receipts within North Dakota. On the mere basis of accounting figures the instant case is less extreme than the North Dakota case, where the net income allocated to the taxing state by the formula exceeded the gross income allocated to the state by separate accounting; yet, in such situation because of the unitary nature of the business, the Supreme Court of North Dakota held that the transactions of buying constituted an essential part of the transactions from which the income collected outside the state was derived.

The Great Atlantic & Pacific Tea Co. case, supra, dealing with a state chain store tax act, bears on the instant issue in that it was there held that the out-of-state stores and central buying and advertising of the buying and selling corporation gave the within-the-state stores advantages which they otherwise would not have had and justified a chain store tax on the within-the-state stores which would otherwise have been, from a constitutional viewpoint, discriminatory. The manifest parallelism between that case and the instant one needs no other comment than the observation that the decision of validity in that case is based on the same reason as that for treating business as unitary in allocating income.

The formula method of allocating or apportioning income in the case of a unitary business was approved by this court in Matson Navigation Co. v. State Board of Equalization, 3 Cal. (2d) 1; affirmed 297 U. S. 728; 56 S. Ct. 553, 80 L. Ed. 1010. In that case it was established that the power of California to tax foreign corporations measured by their net income and the provisions of section 10 of the Bank and Corporation Franchise Tax Act are co-extensive in scope,

and in this connection this court there held that section 10 measures the tax by income from California and excludes from the measure "income from business done entirely outside the State * * *." (3 Cal. (2d) 1, 8). In such case as the instant one, allocation of income to the various states in which the business is done by means of a formula that gives weight to the various factors such as property, services of employees and sales, which are responsible for the earning of income, appears entirely reasonable. To rebut the presumption that the formula produced a fair result, "the burden is on the taxpayer to make oppression manifest by clear, cogent evidence." (Norfolk & Western Ry. Co. v. Maxwell (1936), 297 U. S. 682, 688, 56 S. Ct. 625). In considering the implications of the formula in the last-mentioned case, the Supreme Court of the United States, speaking through Mr. Justice Cardozo, also said at page 688: "* * * a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. The evidence to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. * * *" In the case at bar appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result. Here there has been only an assertion that a loss incurred in this state. As appellant has failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof, for in order to overthrow a formula the taxpayer must introduce such evidence and the evidence must go to each element of the formula equation. (Norfolk & Western Ry. Co. *v.* Maxwell, supra).

In accordance with the foregoing analysis it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation. The reasonable and equitable character of this state's formula, based on factors properly reflecting the relative contribution of the

activities in the various states to the production of the total unitary income so as not to contravene the restrictions implicit in the Fourteenth Amendment against taxing property outside the state, was recognized in Matson Navigation Co. *v.* State Board of Equalization, supra. Accordingly, respondent correctly applied the formula method of apportionment to determine California's portion of appellant's income from the business carried on within and without the state.

Judgment affirmed.

CURTIS, *J.*

We concur:

GIBSON, *C. J.*;

SHENK, *J.*;

CARTER, *J.*

TRAYNOR, *J.*, took no part in the consideration or decision of this case.